two parties.[17] This lack of precedent may be attributed to the fact that the statutes involved in prior cases did not, in specific terms, create such an alternative burden. From the court's language, it is clear that the alternative nature of a tax does not place the obligation imposed by such a tax upon a bankrupt vendor outside the class of exactions awarded priority under Section 64 (a) 4 of the Bankruptcy Act.

R. D. S.

CORPORATIONS

DIVIDENDS OUT OF SURPLUS OTHER THAN EARNED SURPLUS: LIABILITY OF DIRECTORS FOR PAYMENT WITHOUT GIVING NOTICE

Section 38 (paragraph d) of the Ohio General Corporation Act provides:

"Whenever a dividend is paid, in whole or in part, out of other than earned excess of assets appearing on the books of the corporation at the time of the declaration of such dividend, the shareholders receiving such dividend shall be notified as to its source." [1]

At common law and under some statutes surplus other than earned surplus was an available fund out of which to pay dividends.[2] However, as the stockholders did not always realize that part of their investments was being returned in the form of dividends, they were often duped into believing that the corporation was operating profitably and was in excellent financial condition.[3] To correct this condition provisions in the corporation statutes of various

[17] The cases do not go beyond the determination of whether a particular exaction is a debt or a tax in respect to the individual in question, thus disregarding the relationship of the other one of the two parties affected by the tax. New Jersey v. Anderson, 203 U. S. 483, 27 S. Ct. 137, 51 L. Ed. 284 (1906); Matter of Independent Automobile Foundry Co., 118 F. (2d) 537 (1941); *In re* Reimer, 82 F. (2d) 162 (1936); *In re* General Merchandise Corp. of America, 32 F. Supp. 805 (1940).

[1] OHIO G. C. No. 8623-38 (paragraph d).

[2] Equitable Life Assurance Society v. Union Pacific Railroad Co., 212 N. Y. 360, 106 N. E. 92 (1914); Mackintosh v. Flint and Pere Marquette Railway Co., 34 Fed. 582 (C. C. E. D. Mich. 1888); Smith v. Cotting, 231 Mass. 42, 120 N. E. 177 (1918); *See* Weiner, *Theory of Anglo-American Dividend Law; American Statutes and Cases,* (1929) 29 COL. L. REV. 461; Weiner, *Theory of Anglo-American Dividend Law: Surplus and Profits,* (1930) 30 COL. L. REV. 330; (1929) 8 N. C. L. REV. 14; Note, (1931) 31 COL. L. REV. 844.

[3] GATES, OHIO CORPORATION MANUAL, sec. 48, 138. TOWNSEND, OHIO CORPORATION MANUAL, sec. 138.

states, similar to the one above, were enacted.[4] Some states have restricted dividends out of such surplus still further, so that if there is preference stock, only that stock may be paid dividends out of such surplus, and then only if notice is given either prior to or concurrently with such payment.[5] Still others prohibit such dividends altogether.[6]

The wording of the requirement that notice be given should be contrasted with that of a subsequent provision of the same section. Paragraph *e* provides:

". . . A corporation may . . . apply any part or all of any paid-in surplus or any excess of assets however created or arising excepting only surplus arising from revaluation of assets, to the reduction or writing off of any deficit in the account of earned surplus or to the writing off of any particular loss or expense . . . and thereby make available for dividends without notice to the shareholders as to the source of such dividend any earned excess of assets remaining or resulting therefrom or thereafter arising, but in case such action is taken a disclosure thereof shall be made in the next annual statement of the corporation."[7]

As the provision in paragraph *e* is that notice as to the source of the dividend need not be given, but that a disclosure must be made in the next annual statement, it implies that under paragraph

[4] Louisiana, L. 1928 Act 250, Sec. 26; Virginia, CODE, Sec. 3840.

[5] California, DEWING'S CIVIL CODE No. 346, 246b; Illinois, SMITH-HURD REV. STAT. (1933) Chap. 32, Sec. 157.41; Michigan, MICH. STATUTES ANNOTATED, 21.22; Pennsylvania, PURDON'S STATUTES ANNOTATED (1936) title 15, Sec. 2852-704.

[6] Arizona, R. S. 4804 (1928); Missouri, REV. ST. (1929) 5107; North Carolina, MICHIE (1931) CODE Sec. 1179, as amended, L. 1933, Chap. 354, Sec. 1; South Carolina, CRIMINAL CODE No. 1353.

[7] Paragraph *e* seems to be intended to fit the case of a corporation that has been operating and which has an earned surplus, which was subsequently depleted by losses, while paragraph *d* seems to apply to a new corporation starting in business and using the paid-in surplus as a source of dividends (usually on preference stock) until the corporation reaches a profitable point. It is not considered sound financial policy, however, to use paid-in surplus for dividend purposes, even on preference stock, and the better course is to retain the surplus as a cushion to absorb possible future losses. *See* DEWING, FINANCIAL POLICIES OF CORPORATIONS (1934) Sec. 584-604; KEHL, CORPORATE DIVIDENDS (1941) 19, 68-73.

If the corporation reduces its capital and thereby creates a surplus it is more than likely that the availability of such surplus for dividends would be discussed at the time of the approval of the reduction, and that therefore the stockholders would expect that such payment would occur, and so there is less reason for not notifying them of the source of the dividend, although the use of paid-in surplus in a like manner under paragraph *e* seems not much different from the use under paragraph *d*. The Committee on Corporation Law of the Ohio State Bar Association expressed doubts as to the need for continuing either of these provisions for notice. OHIO STATE BAR ASSOC.: COMMITTEE ON CORPORATION LAW REPORT, (1928) p. 52.

d, where notice shall be given, notice in the annual statement is insufficient, and that shareholders should be notified before or at the time of receiving the dividend payment. A trial judge has held that these provisions are merely directory,[8] and it would seem that a dividend, legally authorized and out of an available fund, should not later be considered unlawful because of the failure to give notice as to its source; at least not to such an extent as would make the directors paying such a dividend liable under section 123b of the Ohio Corporation Act.

Especially is this true when we consider the liability of the directors under section 123b (Ohio G. C. Sec. 8623-123b) which provides:

"The directors of a corporation shall not declare or pay dividends or authorize the withdrawal or distribution of any part of its assets except as provided by this act. . .

"In case of any willful or negligent violation of the provisions of this section, the directors, under whose administration this shall have happened (except those who shall dissent as hereinafter provided), shall be jointly and severally liable to the corporation for the full amount of any such unauthorized dividend or distribution with interest at the rate of six percentum per annum until the same shall be paid."

Statutes creating a liability on the part of the directors for illegal payment of dividends have been classed as either provisions for payment of damages,[9] or as penalties against the directors for their

[8] *See*, Scullin v. Mutual Drug Co., 138 Ohio St. 132, 137 (1941). The contention that the provision for notice is merely directory may well be based on the argument that because OHIO G. C. Sec. 8623-38 paragraph *a*, authorizes dividends out of the excess of the assets over the liabilities and stated capital, that full authority has been granted to pay dividends out of other than earned surplus, and the requirement of notice in case of such a payment, coming several paragraphs later, is not a restriction upon the authority granted but merely an instruction.

[9] Whether the statutory liability is penal or remedial depends chiefly upon the wording and construction of the statute. Those making the directors liable for all the debts of the corporation existing at the time of the wrongful declaration are considered penal while those making the directors liable to the creditor in the event of insolvency up to the amount of the illegal dividend are considered remedial. For discussions of the various types of statutes and the cases under them, *see*:
13 AMER. JUR. 743;
3 FLETCHER, CYCLOPEDIA OF CORPORATIONS (Perm. Ed.) Sec. 1209;
12 FLETCHER, CYCLOPEDIA OF CORPORATIONS (Perm. Ed.) 150;
Annotations: 55 A. L. R. 72 (1928);
76 A. L. R. 892 (1932);
109 A. L. R. 1388 (1937).

wrongful acts. Statutes making the directors liable for damages resulting from illegal payment of dividends run afoul of the difficulty of determining the damages to the corporation, such as, for example, estimating the damages resulting from the deprivation of funds that otherwise might have been used for expansion of the business, etc. A determination of whether the Ohio statute provides for damages by saying flatly that the corporation shall be considered as a matter of law as being damaged to the full amount of the unauthorized dividend with interest, or whether it means that the liability of the directors created by the statute is a penalty for their unauthorized acts, seems unnecessary, for it appears from the language of the statute that the legislature meant that regardless of the theory, the directors' liability should always be the full amount of such unauthorized dividends. The restrictions of section 8623-123c on the creditors' derivative right of action to cases where insolvency, general assignment for creditors, receivership, or dissolution exists would imply that actions in favor of the corporation do not depend on any of these factors but are intended to restore the corporation to the position existing before the payment of the unauthorized dividend, or in other words, the directors are liable for the full amount of the unauthorized dividend with interest.

But are dividends out of surplus other than earned surplus where notice of the source is not given unauthorized dividends to the extent that the directors are liable for the full amount of the dividends? It would seem not. Section 8623-123b creates a liability in favor of the corporation with the intention to restore the corporation to its former position. But does failure to give the stockholders notice of the source of the dividend, where the dividend is from a *proper source* at the time of declaration, deprive the corporation of any fund illegally or damage it to any extent, when the corporation would be in the same position financially if notice had been given the stockholders? The provisions for notice of the source of dividends seem clearly for the protection of the stockholder as a stockholder, while the statutory liability of the directors is intended to preserve intact the capital of the corporation for the protection of the creditors and to guard the continued existence of the corporation for the benefit of all the stockholders. These provisions being for the protection of different interests,[10] failure to give notice under the first provision should not make the directors liable under the second. If the directors were liable for such payments, the stockholders would receive the benefit of their liability by having the *surplus available for dividends* restored to the former amount, and thereby have an additional source of funds for future dividends.

While a dividends out of other than earned surplus without notice to the stockholders, comes under a literal interpretation of the directors' liability under sec. 8623-123b, yet because of the difference in interests protected, it would seem that the directors should not be liable under that section for failure to give notice as provided in sec. 8625-38 (paragraphs *d* and *e*).

F. F. V.

PURCHASE OF OWN SHARES BY CORPORATION— FUND AVAILABLE

Proceeding under Ohio G. C. Sec. 8623-14, the defendant corporation, by a two-thirds vote of its shareholders, amended its articles of incorporation so as to relieve it from the obligation of maintaining a sinking fund for the redemption of preferred shares. Plaintiffs, minority shareholders who had voted their shares against the amendment, took advantage of the "appraisal statute," Sec. 8623-72, and demanded that the corporation pay them the "full cash value" for their shares. The corporation refused to pay the price asked, and made a counter offer. Rejecting this, plaintiffs brought suit in the Common Pleas Court of Franklin County to determine the fair cash value and secure a judgment against the corporation. The court sustained a motion to dismiss for failure of proof. Plaintiffs appealed, and following the Court of Appeals order reversing the

[10] It may be argued that the corporation is the stockholders and that therefore the same interest is being protected by both sections of the act. But the interest of the stockholders as an aggregate may well be different from the interest of the individual stockholder. As for example, if dividends out of other than earned surplus are paid to preferred stockholders, does failure to give notice to the preferred stockholders injure the common stockholders when if notice were given to the preferred, the common stockholders would not have cause to complain even though he was kept in ignorance of the payment? If the preferred stock has preference on dissolution, the preference is the full definition of the preferred stock's rights, and precludes the preferred from sharing in the surplus available after payment of par on the preferred and common. Williams v. Renshaw,220 App. Div. 39, 220 N. Y. S. 532 (1927); Murphy v. Richardson Dry Goods Co., 326 Mo. 1, 31 S. W. (2d) 72 (1930). The preferred stockholder therefore does not have the interest in keeping the capital surplus intact that the common stockholders would, and yet in our example the notice if given of the payment out of capital surplus would be to him. The notice seems therefore not for the protection of the aggregate of the stockholders, but only for the stockholder in his individual capacity.